DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

July 10, 2002

Number: **200242001**
Release Date: 10/18/2002
CC:ITA:B07
POSTF-121721-02
UILC: 446.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR CAROL B. MCCLURE
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FROM: Heather C. Maloy
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SUBJECT: A change in method of accounting under §§ 446 and 481 for deducting contributions made to certain pension plans.

This Chief Counsel Advice responds to your memorandum dated April 4, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =
Tax Year 1 =

ISSUE

Whether a change in the criteria used to determine the proper time for deducting contributions made to certain pension plans constitutes a change in method of accounting for purposes of §§ 446 and 481.

CONCLUSION

The application of the new criteria will or could change the proper time for deducting the pension plan contributions and therefore constitutes a change in method of accounting for purposes of §§ 446 and 481.

FACTS

Taxpayer is required to make contributions to various multi-employer pension plans pursuant to negotiated collective bargaining agreements. The plans are qualified pension plans within the meaning of § 401 of the Internal Revenue Code. Under the terms of the collective bargaining agreements , contributions to the plans are required to be made monthly. The contributions are calculated by multiplying the number of hours worked by covered employees during the previous month by the agreed upon contribution rate, as defined in the collective bargaining agreements. Accordingly, each monthly payment generally represents payment for work performed by covered employees in the preceding month.

For more than 15 consecutive taxable years, Taxpayer deducted pension contributions without regard to whether the contributions were attributable to services performed during the taxable year. Taxpayer used only two criteria – the date of the contribution and whether the contribution was deducted in the prior year – to determine whether a pension contribution would be deducted in a taxable year. Stated differently, Taxpayer deducted contributions that were made during the taxable year and were not deducted in the prior taxable year and contributions that were made after the taxable year ended, but before the tax return for the taxable year was filed. Using these criteria, Taxpayer deducted the 3 contributions actually made during the taxable year and after the extended due date of the return for the prior year, plus the 9 contributions made during the first 8½ months of the following year. Under the decisions in Lucky Stores, Inc. and Subsidiaries v. Commissioner, 107 T.C. 1(1996), recons. denied, T.C. M. 1997-70, aff'd., 153 F. 3d 964 (9th Cir. 1998), cert. denied, 119 S. Ct. 1755 (May 17, 1999), Airborne Freight Corp. v. United States, 153 F. 3d 967 (9th Cir. 1998), cert. denied, 119 S. Ct. 1755 (May 17, 1999), and American Stores Co. v. Commissioner, 108 T.C. 178 (1997), aff'd., 170 F. 3d 1267 (10th Cir. 1999), cert. denied, 145 L. Ed 2d 153 (October 4, 1999), the contributions made after the end of the taxable year that were not attributable to services performed during the taxable year were not “on account of” the taxable year within the meaning of section 404(a)(6).

Beginning with Tax Year 1, Taxpayer will be required to apply an additional criterion for determining when pension contributions made after the end of the taxable year are deductible. The new criterion is satisfied only for those post-year end contributions that are attributable to services performed during the taxable year. Thus, Taxpayer will deduct only contributions made to the plans during the taxable year that were not deducted in a prior taxable year and contributions made to the plans after the end of the taxable year, but not later than the extended due date of the tax return for the taxable year, which were attributable to hours of service performed during the taxable year. As a result, Taxpayer will be required to change the taxable year in which it deducts contributions that are both made after the end

of the taxable year and attributable to service rendered after the end of the taxable year.

The Service believes that the required change in treatment of pension contributions constitutes a change in accounting method under § 446. In effecting the change in accounting method for pension contributions, the Service will disallow deductions for contributions made after the end of the year of change that are not attributable to services performed during the year of change. Those contributions will be allowed as deductions in the following taxable year. To the extent that Taxpayer demonstrates that pension contributions made during the year of change that were previously deducted are deductible for the year of change under the new method of accounting, the Service proposes to require Taxpayer to take into account an adjustment under § 481(a) of the Code to prevent a duplication of deductions.

LAW AND ANALYSIS

For many years, Taxpayer consistently deducted all pension contributions actually made during the taxable year that were not deducted in a previous taxable year and all contributions actually made during the period from the end of the taxable year to the date on which Taxpayer's tax return was filed. Thus, in substance, the criteria Taxpayer used to determine whether a contribution was deducted in a taxable year were (1) the date on which the contribution was made and (2) whether the contribution was deducted in the previous taxable year. This method did not distinguish contributions attributable to hours of service performed during the taxable year from contributions attributable to hours of service performed after the end of the taxable year.

Section 404(a)(1)(A) provides that contributions to a pension plan must be actually paid to the trust during the taxable year in order to be deductible. However, under § 404(a)(6), pension plan contributions made after the close of the taxable year, but not later than the due date for filing the return (including extensions), are deemed made on the last day of the taxable year if they are made "on account of" the taxable year. In cases involving multi-employer pension plans, the courts have held that contributions made after the close of the taxable year, but not later than the due date for filing the return, that were attributable to services provided during the succeeding taxable year were not "on account of" the taxable year within the meaning of § 404(a)(6). Lucky Stores Inc., 107 T.C. 1; Airborne Freight Corp., 153 F. 3d 967; American Stores Co. 108 T.C. 178. The mere fact that pension plan contributions made after the end of a taxable year are made before the due date of the tax return for the taxable year does not automatically make them deductible in that taxable year. As a result, the Service will require Taxpayer to change the criteria it uses to determine the taxable year in which it deducts pension plan contributions. Under the new criteria, Taxpayer will deduct in a taxable year only those contributions that are made during the taxable year and those contributions

that are both made on or before the due date of the tax return (including extensions) and are attributable to hours of service performed during the taxable year.

Under § 446(e) and § 1.446-1(e)(2)(i) of the Income Tax Regulations, a taxpayer must secure the consent of the Commissioner before changing the method of accounting used to compute taxable income. A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. See § 1.446-1(e)(2)(ii)(a). "[T]he consistent treatment of a recurring, material item, whether that treatment be correct or incorrect" constitutes a method of accounting. FPL Group, Inc. and Subsidiaries v. Commissioner, 115 T.C. 554, 561 (2000). Because Taxpayer will be required to change the proper time for deducting an item of expense, i.e., pension contributions, the change is a change in the treatment of a material item, and hence, constitutes a change in method of accounting under §§ 446(e) and 481(a).

Taxpayer maintains that the required change in treatment does not constitute a change in accounting method. Taxpayer argues that the change is a "change in characterization." According to Taxpayer, once a factual determination is made as to whether a contribution is made on account of a particular taxable year, the issue of when the contribution is deductible is governed by statute. Taxpayer argues that it is merely changing its factual determination of which taxable year the pension contributions are "on account of" under § 404(a)(6). In support of its argument, Taxpayer cites Underhill v. Commissioner, 45 T.C. 489 (1966), Standard Oil Co. (Indiana) v. Commissioner, 77 T.C. 349 (1981), McPike, Inc. v. United States, 15 Cl. Ct. 94 (1988) and Tate & Lyle, Inc. v. Commissioner, 103 T.C. 656 (1994), rev'd., 87 F.3d 99 (3d. Cir. 1996).

In our view, the law does not support Taxpayer's position. As explained below, we believe that Underhill and Standard Oil are no longer reliable authority and that McPike and Tate & Lyle are distinguishable on their facts. We further believe that Pacific Enters. and Subsidiaries, v. Commissioner, 101 T.C. 1 (1993) and FPL Group are most analogous to Taxpayer's situation and support the Service's position.

The "change in characterization" exception to § 446(e) as expressed in Underhill and Standard Oil does not reflect the current state of the law. The regulations under § 446(e) were amended in 1970 to focus the definition of a "material item" on the timing of income and deductions. See T.D. 7073, 1970-2 C.B. 98. Since the years at issue in Underhill predate the amendment to the regulations, the case clearly carries no precedential value with respect to the current regulations. But more importantly, the Underhill and Standard Oil line of cases "ultimately rest on

the erroneous premise that consent is not required if the taxpayer's previous treatment of the item was improper." Cargill, Inc. v. United States, 91 F. Supp. 2d 1293, 1298 (D. Minn. 2000). Even Judge Tannenwald, who authored the decision in Underhill, recognized in a subsequent opinion that Underhill stands for the outdated proposition that the Commissioner's consent is not needed to change from an impermissible method of accounting. Convergent Techs., Inc. v. Commissioner, T.C. Memo. 1995-320. The Underhill and Standard Oil line of cases have no continuing vitality. Reliance on those cases is misplaced.

McPike and Tate & Lyle do not support Taxpayer's contentions either. In McPike, the taxpayer was engaged in the expansion of a golf course. The taxpayer analyzed individual time sheets to determine the type of activity involved so that the cost could be capitalized if it related to a construction activity, and could be deducted if the cost related to maintenance. As a result of a prior examination, incorrectly allocated payroll costs were reallocated by the Service. The taxpayer then changed its allocation method for subsequent years to conform to the allocation adopted as part of the audit settlement. The taxpayer argued that this constituted a change in accounting method. The McPike court differentiated between a procedure used to learn the facts about a taxpayer's expense and the treatment of that expense by the taxpayer. The court found that the taxpayer's "time sheet examination procedure for determining how much employee time was spent on a particular activity is not a method of accounting, but its treatment of the data (whether capitalization or deduction) derived from the examination does constitute an accounting method."[1] 15 Cl. Ct. 94, 99.

In McPike, the taxpayer analyzed individual time sheets to determine the type of activity involved so that its method of accounting could be applied to determine the treatment of the item. Unlike the taxpayer in McPike, there is no indication that Taxpayer made an analysis of its pension plan contributions to determine whether one contribution was factually different from the next so that its method of accounting could be applied to determine the treatment of the contribution. Taxpayer will not simply change a procedure for determining the facts about a particular contribution, it will apply a new criteria to the facts it gathers to determine whether the contribution is deductible in the current or a subsequent period. This constitutes a change in method of accounting.

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[1]The explanation of the facts and arguments as presented in the McPike opinion is somewhat confusing and the court's holding could be construed to be the same as the since-rejected holdings of Underhill and Standard Oil. In distinguishing McPike, we are not acquiescing in the holding insofar as it can be construed as tantamount to the holdings in Underhill and Standard Oil.

In Tate & Lyle, domestic entities deducted accrued interest payable to a related foreign entity. A foreign corporation's interest income from sources within the United States, which is not effectively connected with a trade or business in the United States, is generally subject to U.S. tax under §§ 881(a)(1) and 1442(a) when the interest is actually received by the foreign payee. Accordingly, the Service contended that under § 267(a)(2) and §1.267(a)-3, the domestic entities were not entitled to deduct the interest until it was actually received and was includable in the foreign entities' income. The Tax Court held for the taxpayer and found that the portion of § 1.267(a)-3 which would preclude the taxpayer from accruing and deducting the interest was invalid. However, we believe that Taxpayer's reliance on the Tax Court's decision and analysis in Tate & Lyle is misplaced.

First, the Tax Court's holding that §1.267(a)-3 was invalid was overturned by the Court of Appeals. Tate & Lyle, Inc. v. Commissioner, 87 F.3d 99 (3d. Cir. 1996). Second, the language relied on by Taxpayer was taken from the court's decision in Underhill. For the reasons stated above, we believe that Underhill has no continuing vitality and reliance on that case is misplaced. However, even if the analysis in Tate & Lyle were applicable, we believe it supports the conclusion that the change in the manner in which Taxpayer accounts for its pension contributions is a change in accounting method.

The analysis in Tate & Lyle focused on the question of whether payments received by the taxpayer were includible or not includible in gross income. The Tate & Lyle court stated that the characterization of an item determines whether that item is includible or not includible in gross income while a method of accounting determines when an item is includible, or deductible, in calculating taxable income. Applying this analysis to expenses, the characterization of an item determines whether that item is deductible or not deductible in calculating taxable income. In the instant case, there is no question concerning the characterization of the contributions being made to the pension plan; they are deductible. The determination by Taxpayer of which year its pension contributions are made "on account of" determines when the contribution is deductible and does not determine the character of the contributions. The determination made by Taxpayer is solely concerned with the timing of the deduction for the contributions. Therefore, the change in how that determination is made is a change in accounting method.

The instant case is more analogous to Pacific Enters. and FPL Group. In Pacific Enters., two subsidiaries owned pipelines and underground storage reservoirs for natural gas. They maintained a static volume of gas in the reservoirs ("cushion gas") that provided the pressure needed to deliver gas ("working gas") to their customers. Both subsidiaries accounted for these pressuring gases as capital assets and the working gas as inventory. The companies reclassified a portion of their working gas to cushion gas, based on engineering reports that some of that gas was needed to maintain pressure in the reservoir and could not be sold to

customers without harming the efficiency of the reservoir. After the reclassification, the reclassified volume of gas was accounted for as a capital asset. The taxpayer did not obtain the Service's approval for the reclassification. The Service determined that the reclassification was a change in accounting method.

The taxpayer in Pacific Enters. maintained that it did not change its method of accounting when it re-estimated the "underlying fact" of the actual cushion gas volume in its reservoirs. Pacific Enterprises argued that the reclassifications should be considered corrections of mathematical or posting errors under § 1.446-1(e)(2)(ii)(b). The court held that the reclassification of working gas to cushion gas was a change in accounting method under § 446(e) because the reclassification deferred income by changing the method of identifying a material item of inventory and that the "reclassification is material, not only because of the large dollar amount involved, but also because it was a change that affected the timing of income." 101 T.C. 1, 23.

Pacific Enterprises was using an inventory accounting method to account for gas that was in fact performing the function of cushion gas. The method it wanted to use was the correct method of accounting for cushion gas. Similarly, Taxpayer has been deducting all contributions made after the end of the taxable year even if some of the contributions are not in fact on account of services provided during the taxable year. The change to begin distinguishing contributions attributable to the preceding taxable year from contributions attributable to the year in which the contribution is made, directly affects the time for deducting the contributions. Accordingly, like the change from an inventory method to a capital asset method for a certain volume of natural gas in Pacific Enters., this change is a change in method of accounting.

In FPL Group, the taxpayer filed consolidated returns with Florida Power, its wholly owned subsidiary. Florida Power, as a regulated electric utility, is required to follow regulatory accounting for financial reporting purposes. For regulatory purposes, property at Florida Power's electric generating plants (electric plants) is considered as consisting of "retirement units" and "minor items of property". A retirement unit is the overall unit of property while the minor items of property are the associated parts or items that compose a retirement unit. Examples of retirement units include air conditioning systems, bridges, elevators, and cars. Under regulatory rules, expenditures for the addition or replacement of a retirement unit are required to be capitalized, while the replacement of a minor item of property is generally deducted as a repair expense. Except for certain specific adjustments, Florida Power used the same characterization of expenditures for tax reporting purposes that it did for regulatory accounting and financial reporting purposes. FPL filed amended returns to re-characterize as repair expenses the retirement unit expenditures that Florida Power had consistently characterized as capital expenditures on the consolidated tax returns. The court found this to be a change in accounting method.

In its determination, the Tax Court noted that "the basic principles apply for purposes of determining a method of accounting; namely, that a consistent method used to determine the tax treatment of a material item is a method of accounting." 115 T.C. 554, 565. Even though some of the retirement unit expenditures may have actually been repairs, by consistently following the regulatory accounting rules for retirement units on its tax returns, the taxpayer had established an accounting method. Re-characterizing as repairs those expenditures that had been consistently treated as capital expenditures resulted in a change in the treatment of a material item and, therefore, a change in accounting method. The re-characterization was not a correction of an error or a change in underlying facts. Here, Taxpayer consistently deducted all contributions made prior to the due date of the return for the taxable year, without regard to whether the contributions related to hours of service performed during the taxable year or hours of service performed after the end of the taxable year. Here, like the taxpayer in FPL Group, Taxpayer routinely followed a pattern when it identified the contributions that it would deduct in a taxable year. This consistent treatment of all of the contributions, even though incorrect, constitutes a method of accounting for Taxpayer's pension contributions. Accordingly, a change in the criteria for determining which pension contributions will be deducted in a taxable year results in a change in the treatment of a material item and, therefore, a change in accounting method.

Through its consistent pattern of deducting in the taxable year all contributions made during the taxable year and before the due date of the tax return, Taxpayer established a method of accounting for its pension plan contributions. The required change to deducting only those contributions that are made during the taxable year and that were not deducted in the previous taxable year and those contributions that are attributable to hours of service performed during the taxable year that are made after the end of the taxable year but before the due date of the return involves the proper time for the taking of a deduction. Accordingly, the examination imposed change in the proper time for deducting Taxpayer's contributions made to the collectively bargained pension plans is a change in method of accounting, requiring an adjustment under § 481(a) to prevent a duplication of deductions.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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Please call if you have any further questions.

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